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Evaluating Offers to ESOP Companies:
The Case for Engaging an Investment Banker

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Evaluating Offers to ESOP Companies: The Case for Engaging an Investment Banker

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Neil Brozen's article in this publication on responding to unsolicited offers to purchase ESOP companies notes that:

- The board of directors needs "to analyze the offer, perhaps with the assistance of a financial advisor."
- "The trustee will encourage the board to engage an investment banker to evaluate the offer and develop a strategy to solicit other potential buyers."
- "The trustee might tell the board it would like the board to seek other potential bidders as well."

This advice is sound. Whether a company is ESOP-owned, family owned, or owned by a private equity fund, shareholders do better in a professionally managed competitive sales process than when negotiating with a single buyer. Shareholders receive significantly more consideration after running a sales process compared to the price that was offered before the competitive process was conducted. There is material support for this assertion. First and foremost is the fact that private equity firms that are regularly in the business of buying and selling portfolio companies almost always use investment bankers to help sell their portfolio companies. One recent survey of private equity firms active in the middle market found that private equity firms use an investment banker 94% of the time when selling their own middle-market portfolio companies.[1] As further support, consider that this same study also found that private equity firms estimate that they end up paying 1x EBITDA (earnings before interest, taxes, depreciation and amortization) more on average when an investment banker is used by the seller (with answers ranging from 0.5x to 2x EBITDA, but never the same or less).

Hiring an investment banker does more than increase total consideration. It is also has a positive impact on other, more difficult to measure benefits that are very important, such as:

- Introducing a wider universe of potential buyers/investors, including both strategic as well as financial buyers, to identify the "right fit" from a business model and a cultural perspective;
- Improving key terms of the transaction beyond just consideration;
- Helping to maximize transaction certainty;
- Establishing a formal environment of confidentiality;
- Helping to prepare the company and management prior to approaching the market;
- Maintaining transaction momentum—"time kills deals";
- Enabling management to remain focused on the core business; and
- Limiting risk by facilitating more thorough due diligence.

These additional benefits should not be ignored. In most cases they are just as important, and in some cases, even more important, than the direct consideration received in a deal, especially for ESOP-owned companies.

The study of private equity firms referred to above found that private equity firms rated the extent that an investment banker makes the due diligence process run more smoothly for the seller and the buyer as an 8.1 out of 10.[2]

1. HighBank Advisors, "Selling Your Business: Separating Myth from Reality and the Importance of Hiring an Experienced Investment Banker," *SmartCEO*, http://smartceo.com/highbank-selling-your-business-separating-myth-from-reality-and-the-importance-of-hiring-an-experienced-investment-banker/.

2. HighBank Advisors, "Selling Your Business."

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Potential buyers making unsolicited bids will often tell a company that if the company participates in an auction process, their offer is "off the table." My experience is that this is usually not the case. In fact, not only does the bidder typically participate in the process, they usually increase their bid as they learn more and get a sense that there is competition. When a potential buyer makes this kind of threat, you should step back and consider why the buyer is trying to create this sort of pressure. First, why do you think they do not want you to shop their offer? The potential buyer knows that if you go through a process you are likely to get a significantly better offer. Simply put, the buyer is trying to purchase the company at a discount to its true fair market value. Even if the offer price is at a significant premium to the annual valuation, that value may not include cost savings, revenue enhancements, and other strategic considerations (like the value to a potential buyer increasing market share, or just plain "fit"). If one bidder sees value at that price, others will usually also. Furthermore, although it may seem quicker and easier to deal with a single party, it usually turns out not to be the case. When a seller is dealing with a single buyer, that buyer has more leverage than they would have had in a competitive process; it is easier for that buyer to make demands on the seller, and such a buyer often "retrades" price and other terms after the seller is too far down the road to pursue other options.

Whether the ESOP is a minority or majority owner, the company's management, the board of directors, the ESOP trustee, and any other stakeholders (including warrant holders) should discuss an offer with a Financial Industry Regulatory Authority (FINRA)-licensed investment banking firm. Most of the time, the investment banking firm will meet with interested parties and provide a "free" assessment as part of their sales effort.

Case Study

Problem

The company started discussions with and received an unsolicited offer from a prospective buyer. The company and buyer agreed to a price (a 15% premium to valuation). After going through due diligence, the buyer and seller were not able to agree on sale terms since the buyer wanted indemnification provisions, a large escrow, and a large earn-out.

Solution

Since word had already gotten out that the company was selling, management was concerned about employee morale and about losing customers to the competition. The board engaged an investment banking firm that ran a process looking for financial or strategic buyers. Strategic buyers felt that significant cost savings and revenue enhancements were available through a merger. Because the investment banker educated the potential buyers on specific issues related to purchasing an ESOP-owned company, the due diligence and negotiation went much smoother. The company wound up selling to a competitor, who agreed to a small escrow and no earn-out. The total consideration exceeded the prior offer by 30% without regard to the earn-out, and by 8% even assuming the full earn-out was achieved.

Fiduciary Duties of the Board and Trustees

Under the Employee Retirement Income Security Act of 1974 (ERISA), an ERISA fiduciary, such as an ESOP trustee, must discharge his or her duties "solely in the interest of the participants and beneficiaries and . . . with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent [person] acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims."[1]

Boards of directors generally are not subject to ERISA's fiduciary duty requirements in relation to the ESOP other than in its selection of the trustee. Rather, boards are generally subject to the fiduciary duties of care and loyalty under state corporate law, which varies from state to state.[2] These fiduciary standards are distinct and different from the fiduciary standards of an ESOP trustee under ERISA. In the sale of a non-ESOP company, the board is usually advised to select a buyer based on a vibrant, competitive process to protect against breach of fiduciary claims. Often, boards are also advised to obtain an opinion directed to them that the consideration is fair from a financial

1. ERISA Section 404(a)(1)(B).
2. See "Fiduciary Issues and Practical Solutions for Boards of Directors in ESOP Companies When Responding to Acquisition Offers" by Stephen P. Magowan in this publication for an extensive discussion of the board's fiduciary duties under state law.

perspective, which opinion is somewhat similar to the opinion given to the ESOP trustee (as discussed below), but often with more detail and complexity, and subject to retroactive scrutiny from FINRA.

The common process for the sale of an ESOP company is very different:

- Management receives an offer that is disclosed to the board, which then makes a determination that the offer should be pursued.
- Management, typically without the assistance of the ESOP trustee, then negotiates with the buyer to achieve what management believes is the best deal possible under the circumstances, taking into consideration the tax structure of the entities and the after-tax proceeds.
- The ESOP trustee then engages a "financial advisor," who updates the ESOP valuation and issues an opinion that the consideration received in the transaction is "adequate consideration" under ERISA Section 3(18) and that the terms of the transaction, taken as a whole, are fair and reasonable to the ESOP from a financial point of view.
  - Since this opinion is directed to the ESOP trustee from an ERISA fiduciary perspective, it is not intended to provide evidence that the board has satisfied its fiduciary duties under state law.
  - Although the opinion addresses adequate consideration as defined in ERISA, this is not necessarily adequacy from a financial perspective in the context of a sale to a strategic buyer after taking into account strategic considerations (e.g., taking out a competitor) or cost savings and revenue enhancements.
  - The financial advisor explicitly states that it is not acting in a fiduciary capacity in reaching this opinion.
- The board then approves the transaction and related documentation (often without the benefit of a price determined by a competitive process or an opinion directed to them that the consideration of the transaction is fair from a financial perspective) and directs that the transaction be submitted to the trustee and other shareholders.
- The trustee then relies on the non-fiduciary fairness opinion to determine that the transaction satisfies ERISA's fiduciary requirements to act solely in the interests of the participants and beneficiaries and either approves or rejects the transaction.

However, this type of process leaves critical questions unanswered. Would the ESOP's participants and beneficiaries, as well as the other relevant stakeholders, have received more consideration and/or better terms if the company and trustee had engaged an investment banker to run a professionally managed competitive sales process? To what extent can a director rely on the trustee's fairness opinion in connection with meeting his or her fiduciary duties?

As discussed above, smart money private equity investors who regularly engage in buying and selling portfolio companies and are trying to achieve the highest possible returns almost always run a competitive sales process. If it is prudent for a private equity company to run a competitive process, why wouldn't management, the board of directors, the ESOP trustee, and any other stakeholders do the same to fulfill their duties?

Getting Free Advice

Although nothing in life is free, asking an investment banker to discuss a potential transaction may be about as close as it gets. Most investment bankers are eager to meet with companies that may be sold. In these meetings, the investment banker will discuss the typical transaction process. More importantly, if investment bankers are provided sufficient information in advance, they will also provide detailed feedback on where they believe the transaction will be valued in a competitive process and the likelihood of reaching a successful conclusion. Also, most investment banking fees are not only dependent on the price obtained but also contingent on a successful transaction. Therefore, if the fee is structured properly (as discussed below), then you will have a clear indication of the anticipated market value of the company.

The Competitive Process

During the initial phases of an engagement, an investment banker works to understand the importance of the following considerations:

- Maximization of value and after-tax net proceeds
- Financial and tax considerations
- Transaction certainty and timing
- Risk allocation for pre-closing acts or omissions discovered after closing
- Desire of management to continue with the company after the transaction
- Impact on other shareholders, family members, customers, suppliers, and/or creditors
- Impact on management, employees, and communities
- Different goals and objectives among other stakeholders
- Protection of management and directors from post-closing liabilities to stakeholders in connection with pricing and other terms
- Continuation of company name and corporate culture

Once the objectives and priorities are established, the investment banker tailors the process and the transaction structure to best address these considerations.

The typical process involves the investment banker performing some level of due diligence on both the company and the industry. Based on the results of that due diligence, the investment banker prepares "go-to-market" documents, including a "no-name" company summary, a confidentiality agreement, and a confidential information memorandum. The investment banker also researches and identifies potential buyers and/or investors. Working with the company, the investment banker will determine which potential buyers and investors to contact. A quality investment banker, working with the owner, management, and legal advisors, will also prepare an online data room and populate it with appropriate files.

When it is time to go to market, the investment banker will contact prospects on a "no-name" basis. To the extent that prospects show interest based on the summary "no-name" information and before receiving any confidential information, the prospects sign a confidentiality agreement. Once the confidentiality agreement is in place, the investment banker distributes the confidential information memorandum to potential buyers. After reviewing the confidential information memorandum and having a chance to discuss the company with the investment banker, the prospects are asked to submit preliminary or first-round bids. To the extent there are discrepancies, the banker will work with the prospect to make sure that all of the bids are made on terms that can be accurately compared and contrasted. The banker will then review first-round bids with the trustee, other stakeholders, and management to select which prospects should have access to a data room, meet with management, and participate in facility tours. After such access, management presentations, and tours, the banker will solicit and negotiate second-round bids.

To facilitate a purchase agreement that can be "bidded" as part of the competitive process, many bankers will work with company counsel to draft a term sheet or purchase agreement and ask remaining bidders to comment on the document before picking a winner. As bidders go through their due diligence pro-

Case Study

Problem

A direct competitor approached the company's president about buying the company. The buyer wanted to sign a letter of intent that would provide it with a 90-day exclusivity period, financing, and due diligence outs, and said it would pay a 10% premium to the company's prior valuation.

Solution

The company's board of directors was concerned that this buyer might not be capable of consummating the transaction. The board asked an investment banking firm to present alternatives to selling to this buyer. The investment banker explained that before going exclusive and providing full access to the company's books and records, they should first receive a source-of-funds statement from the buyer. The buyer disclosed that it was planning to 100% bank finance the transaction. The company and the investment banker both agreed that receiving 100% bank financing was not likely. Also, the investment banker felt that they could do better in a competitive process. The company engaged the investment banker to run a process. The investment banker received 11 indications of interest, invited 6 in for management meetings, and received 3 offers, all above the unsolicited bid and all with sufficient financing. The company ultimately accepted an offer and closed a $28 million all-cash transaction.

cess, the banker will work with management to answer questions from and additional due diligence requests of bidders. After questions have been answered, the bidders will be asked to submit a final-round bid, letters of intent (typically binding the bidder to purchase the company with as few "outs" as possible) and a "mark-up" of the transaction agreements. The investment banker works with the trustee, stakeholders, and management to choose a bidder to move to the final phase. The process is always fluid, sometimes requiring fewer and sometimes more "rounds" of bidding, sometimes moving more quickly to negotiating with a single party, but almost always with the attempt to keep it competitive as long as possible.

In the final phase, the investment banker leads the negotiation of the "business" and "economic" issues in the transaction documents. The investment banker attempts to maximize after-tax net proceeds, minimize escrows and indemnity exposure, and maximize transaction certainty. The investment banker will interface with the company's other advisors (lawyers, accountants, trustees, etc.) to make sure that the process goes as smoothly as possible. Most importantly, the investment banker should be maintaining transaction momentum and sense of urgency until close.

Table 1 provides an overview of the typical phases of an investment banker engagement.

Typical Engagement Timeline and Fees

Although every engagement is different and presents unique and often unanticipated challenges, it is always a long, complex process. If everything goes according to plan, the process takes around six months. However, even the insertion of the most seemingly innocuous event can add months to the timeline. A good investment banker will attempt to maintain deal momentum throughout the process, even when unexpected delays occur. See figure 1 for an illustration of a timeline.

Table 1. Typical phases engagement overview

Evaluation	Preparation	Solicitation	Negotiation	Finalization

• Determine stakeholder objectives and priorities
  ◦ Economic
  ◦ Family
  ◦ Management
  ◦ Continued involvement
  ◦ Company name and culture
  ◦ Community
• Perform preliminary analysis of company and industry
• Research market environment
• Negotiate and sign engagement agreement with trustee, stakeholders, and company
	• Perform company and industry due diligence
	• Prepare documents to "go to market"
	  ◦ "No-name" company summary
	  ◦ Confidentiality agreement
	  ◦ Memorandum
	• Research and identify potential buyers/investors
	• Determine potential buyers/investors to contact
	• Prepare buyer/investor data room files
		• Contact potential buyers/investors on a "no-name" basis
		• Sign confidentiality agreements with potential buyers/investors
		• Distribute memorandum to potential buyers
		• Solicit and negotiate first-round bids
		• Review potential buyers/investors with trustee, stakeholders, and company to select potential buyers/investors to meet with management and participate in facility tours
		• Hold management presentations/tours
		• Solicit and negotiate second-round bids
			• Provide data room files to remaining potential buyers/investors
			• Distribute draft purchase agreement to remaining potential buyers
			• Address due diligence questions and requests
			• Solicit and negotiate third-round bids/letters of intent and "mark-ups" to the transaction agreement (additional bid rounds may be required or desired depending on the process)
			• Work with trustee, stakeholders, and company to choose a potential buyer/investor to move to the final phase
				• Lead negotiation of the "business" and "economic" issues in the transaction documents
				• Maximize after-tax net proceeds
				• Minimize escrows and indemnity exposure
				• Interface with client's other advisors
				  ◦ Legal
				  ◦ Accounting/tax
				  ◦ Trustee
				• Coordinate and manage final buyer/investor due diligence
				• Maintain transaction momentum and sense of urgency until close

In each phase, the client has the opportunity to control the direction of the process.

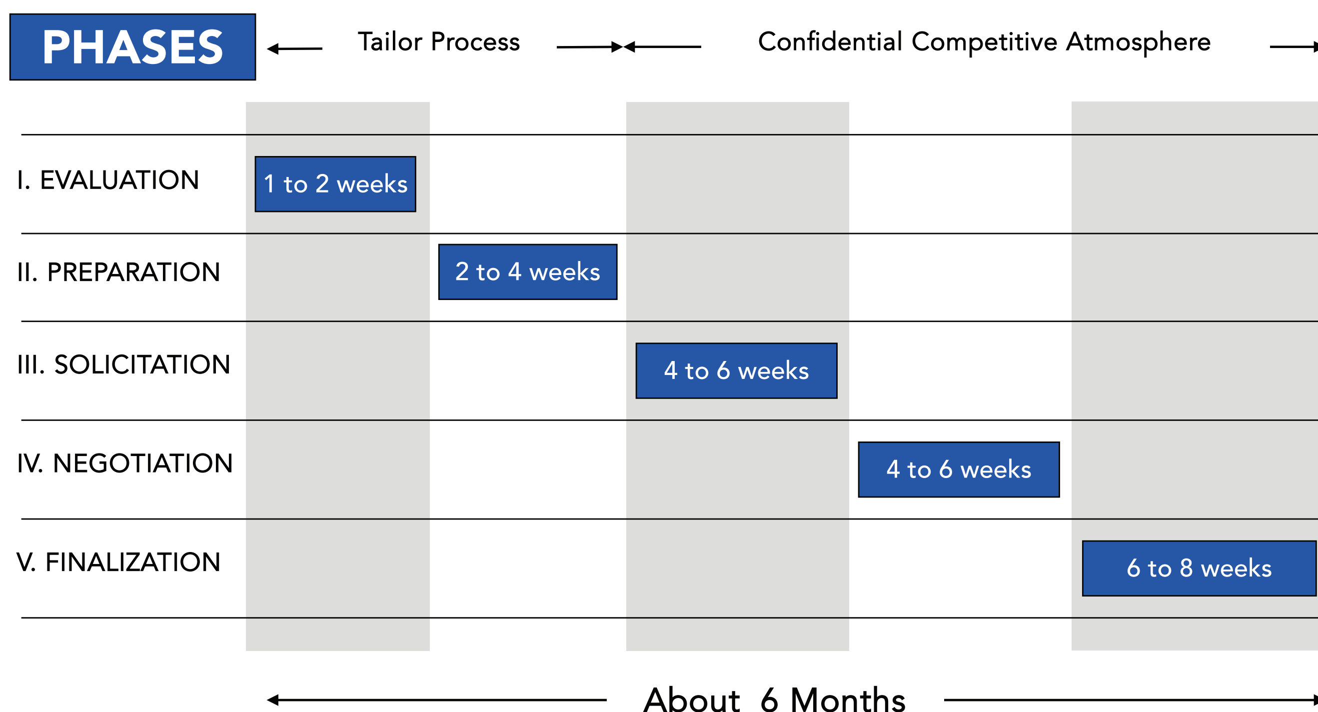

Figure 1. Typical engagement timeline

Most bankers work primarily on a contingent fee basis. There is typically a retainer fee that is paid up front. This fee is charged to make sure that the client is committed to the process and is not just shopping to see what the company is worth. Although the up-front retainer is a small percentage of the total fee, it needs to be enough to make sure that the client is committed and that the interests of the company and the investment banker are aligned (i.e., both parties need to have "skin in the game").

The bulk of the fee is usually variable and based on the sale price of the company. Although there are different formulas used by different investment bankers, one method that works well and aligns the interest of the stakeholders and the investment banker is called a Reverse Lehman formula. The Reverse Lehman formula calls for the fee to be based on one percentage of enterprise value up to a base value (which is mutually agreed upon by the banker and the company, often based on the value received in an unsolicited offer). A higher percentage is applied to the enterprise value over that base value. This type of fee better aligns the interest of the banker and the stakeholders to achieve the maximum transaction value.

Advantages of Dealing with a Licensed Investment Banking Firm

With very few exceptions, only firms licensed under state or federal statutes can act as a company's representative and legally collect a commission or success fee for helping sell a company. The gold standard is investment bankers licensed as broker-dealers by FINRA. FINRA regularly examines all licensed firms to determine compliance with FINRA's rules and those of the SEC and the Municipal Securities Rulemaking Board (MSRB). FINRA evaluates a firm's supervisory system and determines whether adequate financial and operational systems are in place. It also requires individual licensees to pass qualification exams to demonstrate competence in their particular activities. FINRA, in conjunction with other self-regulatory organizations and the Securities Industry/Regulatory Council on Continuing Education, administers the continuing education program for the securities industry. FINRA operates a central licensing and registration system that provides the qualification, employment, and disclosure histories of active registered individuals. Finally, FINRA provides a formal process to determine and enforce breaches of regulatory or ethical rules and provides transparency for such matters.

Business brokers are not subject to examination, supervision, continuing education, and other regulations of FINRA. Most business brokers also do not have the same research and analysis capabilities or access to investors, and they typically do not conduct the same rigorous process as do investment bankers.

Closing Thoughts

Selling a business is not like selling a house. There is no Multiple Listing Service. Usually, there are no readily available reliable "comparables." One cannot simply put a sign in one's yard and wait for offers to follow. In addition to maximizing sales proceeds, the seller should be concerned about minimizing legal liability, maintaining confidentiality, maintaining deal momentum, and otherwise minimizing execution risk. These concerns need to be addressed throughout the sales process, while at the same time management needs to stay focused on running the business.

These issues are exacerbated when a company is ESOP-owned. In addition to dealing with all of the normal concerns of selling a business, advisors also need to understand the intricacies of unallocated shares, ESOP leverage, when participant pass-through voting is required, and receiving not just board approval but also approval of the ESOP trustee. The board and trustee have the additional concern of participating in a transaction and fulfilling their fiduciary duties, both to the company and its stakeholders, while also following ERISA and state laws. By running a professionally managed, vibrant process with a licensed investment banker who has ESOP expertise, all parties can be assured that they have done everything possible to maximize value for those stakeholders.

Mark Russell, *a senior managing director of Griffin Financial Group, helps ESOP-owned companies conduct a competitive sale process. Mark also helps companies determine the feasibility of an ESOP and whether an ESOP is the appropriate vehicle for the relevant stakeholders. Where the ESOP is not the right fit, Mark assists owners in determining what alternative structure is more appropriate.*